Australian Association of Permanent Building Societies Inc

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Mr Matthew Crooke
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Dear Matthew

Deposit Insurance

We refer to our previous submission (July 2004) on the Government Discussion Paper on Financial System Guarantees, and to our subsequent meeting with you and Ms Kanwaljit Kaur in Sydney on 4 August 2004.

We are grateful to have had the opportunity to reiterate our serious concerns about the prospect of an explicit guarantee scheme being introduced for building societies and other authorised deposit-taking institutions (ADIs).

Two questions were posed by you during that meeting:

1. How do ADIs manage their liquidity so as to avert a liquidity crisis.

2. What recourse is available to a depositor if, as a result of a liquidity crisis or insolvency, he is not able to access his funds.

Managing liquidity

As we mentioned to you at the meeting, there are significant safeguards that have been built into an ADI's liquidity management, as well as a number of "triggers" that alert an ADI (and APRA) of liquidity concerns long before a liquidity crisis arises.

1. Capital adequacy

Under APRA's Prudential Standard *APS 110 – Capital Adequacy*, an ADI is required to 'hold capital as a buffer to absorb unanticipated losses from its activities and, in the event of problems, enabling the ADI to continue to operate in a sound and viable manner while the problems are addressed or resolved'.

The Basel II Consultative Document dated 31 July 2004 continues this theme: "As one of the principal objectives of supervision is the protection of depositors, it is essential to ensure that capital recognised in capital adequacy measures is readily available for those depositors".

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APS 110 requires an ADI to maintain, at a minimum, a risk-based capital ratio of 8 per cent at all times. Typically, however, ADIs maintain a minimum capital ratio above 8 per cent.

2. Large exposures

Under APRA's Prudential Standard *APS 221 – Large Exposures,* an ADI is required to ensure that:

(a) adequate systems and controls are in place to identify, measure, monitor and report large exposures and risk concentrations of the ADI; and

(b) large exposures and risk concentrations of the ADI are kept under regular review.

An ADI is required to conduct stress testing and scenario analysis of its large exposures and risk concentrations to assess the impact of changes in market conditions or key risk factors (e.g. economic cycles, interest rate, liquidity conditions or other market movements) on its risk profile and earnings.

3. Liquidity Management Policies

More specifically, APRA's Prudential Standard *APS 210 – Liquidity*, aims to ensure that all ADIs have sufficient liquidity to meet obligations as they fall due across a wide range of operating circumstances.

Under the Standard, the board of directors and management of an ADI are required to implement and maintain a liquidity management strategy that is appropriate for the operations of the ADI.

APRA must be notified immediately of any concerns an ADI has about its current or future liquidity, as well as its plans to address these concerns.

We **enclose** for your information the Liquidity Management Policies of two Building Societies which:

(a) describe in detail a system for measuring, assessing and reporting liquidity;

(c) prescribe the procedures for managing liquidity;

(d) clearly define managerial responsibilities and controls; and

(e) contain a formal contingency plan for dealing with a liquidity crisis.

APRA has of course reviewed and approved each of these Liquidity Management Policies in terms of adequacy and appropriateness. Due to the commercial sensitivity of liquidity management arrangements, we have de-identified these documents.

As required by the Prudential Standard, the Liquidity Management Policies include at least two scenarios:

(a) "going-concern", which refers to the "normal" behaviour of cash flows in the ordinary course of business; and

(b) "name crisis", which refers to the behaviour of cash flows in adverse operating circumstances specific to the ADI, where it has significant difficulty in rolling over or replacing its liabilities.

The ADI's scenario analysis demonstrates:

(i) how obligations and commitments are met on a day-to-day basis; and

(ii) that there is sufficient liquidity available to the ADI to keep it operating for at least five business days in a name crisis.

In practice, ADIs forecast liquidity days, weeks and even months ahead (and monitor seasonal and annual trends). On a daily basis, they forecast cash requirements and invest surplus cash. Cashflow monitoring is automated and is typically done throughout the day and takes 5 – 10 seconds by specific computer programme and is accurate to the cent.

There are escalation or alert points built into ADIs liquidity policies such that, at pre-set liquidity levels certain remedial actions are commenced, such as:

- increasing deposit rates;
- initiating advertising for deposit products;
- drawing down pre-arranged liquidity stand-by facilities (see below);
- organising sales into securitisation facilities (see below);
- slowing the rate of lending; and
- arranging new liquidity loans from other ADIs.

Physical cash can be arranged and delivered at short notice via Chubb, Armaguard etc.

4. Securitisation

Securitisation can be used as a liquidity management tool.

Nine out of fourteen building societies participate in securitisation programs, whereby, at a time of their choosing, the ownership of loans having certain attributes are transferred to the program in return for payment that is both unencumbered and immediately available.

5. Committed lines of credit

Pre-arranged lines of credit can also be used as a liquidity management tool.

These lines of credit are typically standby loan facilities or, more recently, short-term commercial bill facilities (30 days). They may be used either to bridge a short-term cash deficiency or provide time for a longer term solution to be implemented.

6. Prefunding in Exchange Settlement Accounts

With the advent of ATMs, EFTPOS, telephone and internet banking, a "run" may not be evident from queues of people at ADI branches.

In the case of ATMs and EFTPOS, depositors have access to their funds through a multitude of other organisations (eg. retailers and other ADIs), and

the issuer ADI "borrows" from those organisations on what is effectively a daylight overdraft – with settlement occurring at end of day.

Settlement occurs via the ADI's Exchange Settlement Accounts (ESA) at the Reserve Bank. To promote confidence in the system, ESAs contain pre-funding that is equivalent to the highest aggregate daily settlement amount achieved to date (and the highest aggregate is typically over the 4 or 5 day Easter break and is several times a normal day's settlement).

7. RTGS

Settlement is effected via the RBA's Real Time Gross Settlement System (RTGS). The RTGS system has a feature that assists in liquidity management. An "auto-offset" mechanism searches continuously for offsetting transactions. Thus, if A is making a payment to B, the system will automatically offset any payments being made by B to A, thus reducing or eliminating any debit to A's ESA.

<u>What recourse is available to a depositor in the event of a liquidity crisis</u>

You will appreciate from the above that liquidity is central to the operations of an ADI and the protection of depositors. Every effort is made by ADIs to ensure that liquidity is constantly monitored and carefully managed. If despite this, a liquidity crisis cannot be averted, a depositor in an affected ADI may take comfort in the following.

APRA's powers

As noted above, if an ADI has concerns about its current or future liquidity profile, it is required to inform APRA of the problem and of the steps it is taking to rectify the situation long before a liquidity crisis may arise.

APRA may exercise its power to take control of an ADI or appoint a statutory manager (under the direction of APRA) to replace the board and management of an ADI if the ADI informs APRA, or APRA considers, that the ADI is likely to become unable to meet its obligations or that it is about to suspend payment.

As a last resort, APRA may apply for the ADI to be wound up — to allow the closure of an ADI and distribution of its assets before the potential losses become too great.

Transfer of engagements

However, the most convenient and practical means of dealing with the prospective failure of a financial institution, is to find a willing buyer or buyers of the assets and liabilities. In the prudential context, this is often known as a transfer of business (or transfer of engagements).

The Transfers of Business Act provides a convenient legal mechanism whereby the assets and liabilities of the transferring institution can be vested in the receiving institution with minimum disruption to depositors.

Depositor preference

Depositor preference arrangements provide for the proceeds from liquidating the assets of a bank, building society or credit union to first meet liabilities to depositors, in priority to other creditors. Importantly, this can occur prior to entering the liquidation process that would meet the claims of other creditors.

Lender of last resort

While it is the responsibility of an ADI's board to ensure that the ADI has sufficient liquidity to meet its obligations as they fall due, the RBA is nonetheless able to provide emergency liquidity support to the financial system if financial disturbances arise. The RBA will consider applications for emergency liquidity support from any institution supervised by APRA provided it is not insolvent. The Reserve Bank has made it clear that its balance sheet is not available to prop up insolvent institutions (Macfarlane 1999).

Conclusion

We appreciate that none of the above will ensure that a depositor will get his money back on the same day as the ADI in question experiences a liquidity crisis. However, we point out that an explicit guarantee scheme as outlined in Option C of the Government's Discussion Paper would not be able to provide a depositor with immediate relief either.

You also asked us to provide you with our thoughts on the design features of a deposit insurance scheme. I **enclose** a position paper generally supported by our members.

Should you wish to discuss any of the issues raised in this submission further, please do not hesitate to contact me on 02 9221 2711.

Yours sincerely

RAJ VENGA
EXECUTIVE DIRECTOR